

Do State and Party Interventions Help Firm Performance in China?

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66 *China's state-guided economic miracle has revitalized a long-standing and unsettled debate about the role of government in transformative economic development. In a firm-level study of corporate governance, we examine whether direct state involvement positively contributes to the economic performance of newly incorporated firms in China's urban economy. We show that direct governance interventions are likely to yield negative economic effects at the firm level. Our findings indicate that other types of government interventions external to the firm explain the success of China's developmental state in promoting rapid economic growth.*

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The causal mechanisms of China's economic success are not yet well understood. Is China's economic success because of government's organizational capacity to monitor and intervene in firms' decisions? Or is China's success, quite to the contrary, built on the gradual liberalization of product and labor markets, increasing openness to foreign trade, investment in infrastructure, and institutional reforms such as property reforms and quasi-privatization that provide individual actors with sufficient security for planning, investing, and economic risk taking?

State Interference in China's Firms

Since the start of state-guided economic reform, the government's priority has been to rebuild and modernize China's bureaucracy. The decade-long tumultuous upheaval of Mao's Cultural Revolution demoralized and crippled China's state apparatus. At the outset of market-oriented reforms, leaders realized that they must modernize the bureaucracy before they could effectively implement their ambitious new policies. The administrative reforms of the 1980s allowed government regulations and procedural guidelines to become increasingly precise and transparent, increased the predictability of bureaucratic decisions, and reduced the uncertainties of economic planning.

As in other East Asian developmental states, China's development strategy has focused on formulating and implementing industrial policy. In 1989, the government perceived that the old planning apparatus was obsolete for steering economic priorities—particularly industrial development—in China's liberalized market environment. In response, governmental leaders implemented the first so-called industrial policy (chanye zhengce) guidelines. Since then, the

government has frequently revised and reformulated industrial priorities to influence future winners and losers in the ongoing economic structural transformation. To impact the direction of structural transformation, the government uses such common approaches as taxation, loan decisions, and market entry regulation.

To drive out Maoist bureaucrats who were impeding progress in market-oriented economic reforms, 1980s administrative reforms introduced strict retirement ages for government officials and a one-time buy-out strategy for retirees. Reformers also sought to modernize the bureaucracy by implementing merit-based entrance exams and promotion schemes. Most new entrants were university graduates, which significantly increased average education levels.

In the mid-1980s, China's fiscal reform led to a key institutional innovation that altered the relationship between levels of government. The policy of fiscal decentralization strengthened the economic incentives of municipal and provincial governments to support market-oriented economic reform. First, enterprises were to be taxed according to a fixed rate, with the residual left to the enterprise to improve incentives for managers of state-owned enterprises. Second, the tax revenue that a government jurisdiction collected from enterprises was assigned a fixed rate. Local government was given residual claim above the contracted amount to be given to the next higher level of government. The more local firms prospered, the faster would be the region's economic growth, and the greater would be the residual available to the government jurisdiction.

Through post-Mao structural reforms, the Chinese state has evolved into a developmental state basically similar to its East Asian counterparts in Taiwan, South Korea, and Singapore. However, it differs from these states in that the Chinese Communist Party retains coordination rights alongside the government bureaucracy. Thus, local party committees provide a second channel of state involvement in China.

Research Method

We used data on corporate governance of firms listed on the Shanghai Stock Exchange. The Exchange distributed our questionnaires to each of the 483 listed firms. Of these, 257 returned the questionnaires (response rate: 53.54%). After eliminating firms with incomplete data, our final sample included 66 firms, which still represents 14% of the A-share market on the SSE. Respondents (secretaries to chairmen of the board of directors) rated the decision-making power (at end-1999) of managers, boards of directors, shareholders (through shareholders' meetings), and state actors such as local party committees and the responsible bureaus of government administration in sixty-three types of firm decisions including performance appraisals, organizational changes, strategic planning, external relationships, finance and investments, and appointment and dismissal of key personnel. Responses were scaled 1 (no involvement), 2 (some influence), 3 (significant influence), 4 (decisive influence), or 5 (complete control).

In general, the survey confirmed that within China's listed firms, decision-making power is distributed among managers, shareholders, and boards of directors in ways that are similar to the corresponding distribution among Western-style firms. Across 63 decision areas, boards of directors

were most heavily involved in decision making (mean = 3.61), followed by managers (mean=3.02), followed by shareholders (mean = 2.66). Nonetheless, party committees (mean = 1.65) and government bureaus (mean = 1.25) remained directly involved in decision making, although state control has been significantly weakened since the pre-reform era. We used data on party and government involvement over 63 corporate decisions to construct four measures of state intervention.

For each firm, we constructed an index of overall party (PIA) and government intervention (GIA) by averaging the level of involvement of the local party committee and the responsible government bureaus, respectively, in all decisions. We also investigated specific domains of such interventions by grouping corporate decisions into three broad clusters—personnel, financial, and strategic.

We evaluated the effects of state interventions through two indicators of a firm's profitability: return on assets and return on equity.

Results and Implications

We found that Chinese state interventions failed to provide positive economic effects for firms. Significantly, when government was involved in personnel and strategy, respondents reported negative effects. Party intervention yielded significant negative effects in financial decisions and in overall perspective. In spite of an encompassing decentralization of state-share administration, strengthened fiscal incentives, improved monitoring, and enhanced information capabilities of local government officials, we found no positive economic effects resulting from government intervention.

Thus, we believe that fiscal federalism and the resulting incentive effects fail to substantially affect the government's ability to intervene entrepreneurially. Our findings, however, recognize that the Chinese state has played a strong developmental role in facilitating and shaping China's dynamic growth process. We suggest that entrepreneurial government involvement reaching directly into the firm has not built China's success story. Rather, we suspect that the state's ability to create and maintain a supportive growth climate has allowed the gradual liberalization of product and labor markets, increasing openness to foreign trade, and investment in infrastructure and institutional reforms such as property reforms and privatization. Those actions have given firms sufficient security for planning, investing, and economic risk-taking.

This version is based on the full article, "Development State and Corporate Governance in China," *Management Organization Review*, 2007, 3 (1), 19-53. Victor Nee (vgn1@cornell.edu) is Frank and Rosa Rhodes professor at Cornell University, Sonja Oppen, Lund University, and Sonia M.L. Wong, Lingnan University.